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SUBJECT: COLOMBIAN CONSTITUTIONAL MANDATE REDUCES SPENDING FLEXIBILITY

REF: BOGOTA 012032

**¶1. SUMMARY:** The Colombian constitution requires that the central government transfer funds to departments, which are equivalent to states in the U.S. The transfers are the primary source of revenue for the departments, and fund key programs such as education and healthcare. In some departments, especially those with a large narco-terrorist presence, the combination of government transfers and non-renewable resource royalties represents almost 100 percent of revenue. In 2006, the GOC is budgeted to spend more than USD 8.2 billion on transfers (about 15 percent of the budget) and a new constitutionally mandated scheme set to come into effect in 2009 will dramatically increase those outlays. The GOC lists reform of the transfer system as one of its key fiscal priorities, and aims to increase accountability of the departments once the money is received.

END SUMMARY.

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WHAT ARE TRANSFERS  
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**¶2.** The source of government transfers to the regions is both national taxes and internal financing. Transfers are destined for social spending purposes such as education, healthcare and potable water. The 2006 transfer calculation uses the total 2005 transfer as the base and is increased by inflation plus 2.5 percent (4.86 - 2.5). In 2009, the transfer calculation will change, using the previous year as the base plus an average of the last four years, increases in tax collection. The average annual increase in revenue generation between 2002 and 2005 was more than 14 percent. With this trend expected to continue, the central government will be obligated under this new scheme to increase transfers at an annual rate of 10 percent or more.

TAX CHART (in billions of USD)

YEAR	COLLECTED	GROWTH
2002	12.24	
2003	14.348	17 percent
2004	16.828	17 percent
2005	19.333	15 percent
2006	21.333	10.3 percent (projected)

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HOW MUCH IS TRANSFERRED?  
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	2002	2003	2004	2005	2006
TOTAL Transfer	4.9	5.7	6.2	6.7	7.2
Percent of Budget	17.4	19.6	18.4	16.6	15.5
Percent of GDP	5.0	5.6	5.4	5.6	5.7
(in billions USD)					

Royalties	813m	1.0	753m	917m	1.2
TOTAL Transferred to regional governments	5.7b	6.7b	6.9b	7.6b	8.2b

(USD exchange rate 2250 = 1 USD and in billions USD)

¶ 13. Congress approved a change to the transfer regime in 2003, which complemented the Central Bank's inflation targeting strategy. Changing the formula to use a steadily decreasing inflation rate as the multiplier led to a steadily falling transfer allotment growth rate during the last three years. While the GOC is concerned with this large budget burden, the departments depend almost exclusively on this source of revenue.

¶ 14. The departments, municipalities and districts are required to spend this money according to the following functional category distribution:

	2002	2003	2004	2005	2006
Education	60	56	46	47	46.5
Health	23	23.5	23	22	24.5
Housing	1	7	6	6	4
Welfare	15	8	14.5	15	14
Culture	0	1	1	0.5	1
Environment	0	0	0.5	0.5	1
Non-Social spending	0	4	9	9	9

(Percent per category)

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THE PROBLEM WITH TRANSFERS  
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¶ 15. While the departments are pleased with transfers and look forward to receiving more money in the future, the central government considers transfers as problematic because they severely limit spending flexibility. Nearly two-thirds of the GOC's budget is assigned to constitutionally mandated

categories (debt service, pensions and territorial transfers). Transfers alone account for 15 percent of the 2006 national budget, although this is down from 16.6 percent in 2005. Luz Stella Carrillo, from the Territorial Transfers Office of the Department of Planning, said that the transfer regime needs serious changes because the current system is not fiscally sustainable for the medium-term or long-term.

¶ 16. A second problem with transfers is that departments are not held accountable for how the funds are used. The GOC's VISION 2019 plan specifically addresses this issue by proposing changes to the entire transfer regime. To date, the GOC has no mechanism or legal mandate to closely monitor the use of transfers. Non-renewable resource royalties, which are also used for education, potable water, roadways and healthcare, are heavily monitored by two separate government agencies. Monitoring was implemented only in the last two years because evidence was found that royalty funds were being diverted to narco-terrorist groups. Only the Magdalena, Guajira, and Cordoba departments (and their recipient municipalities) met all reporting, spending, contracting, and results requirements in 2005.

¶ 17. Lastly, the transfer growth rate is expected to skyrocket when the formula changes to use a percent of growth of revenues vs. the current calculation (previous year's inflation plus 2.5 percent). Meanwhile, royalties from oil and mineral production are projected to decline as Colombia's oil exports drop.

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COMMENT  
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¶ 18. Nearly two-thirds of the GOC's budget is assigned to constitutionally mandated categories: debt service, pensions and territorial transfers, limiting fiscal flexibility. Constitutionally mandated increases in transfers, post the 2009 transfer regime change, along with projected decreases in oil export royalties, will make changes to the regime politically unfeasible. The real culprit; however, are the lack of adequate departmental taxes and the absence of

incentives for the departments to self-finance. Outside of urban areas, land and real property taxes are virtually nonexistent. The GOC has not clarified what strategy it will use to move the transfer reforms through Congress, but has affirmed that it will address this issue early in the next term. Current priorities, i.e., elections, the free trade agreement, and tax reform are consuming much of the available political energy. The GOC, possibly a second Uribe administration, should address this issue early in the term before an important source of regional government financing (i.e. royalties) literally dries up<sup>8</sup> and dependence on the transfer regime further solidifies.

DRUCKER